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TAGS: ECON EFIN EINV PGOV MY
SUBJECT: TREASURY DAS DOHNER'S VISIT TO MALAYSIA

REF: KUALA LUMPUR 00543

¶1. (U) Summary: Treasury Deputy Assistant Secretary for Asia Robert Dohner briefed Bank Negara officials on the U.S. economic and financial situation and exchanged views on Treasury's decision to include Malaysia in the executive summary of the U.S. Foreign Exchange Report. DAS Dohner defended the Treasury report as fair, and offered Bank Negara expanded opportunities to consult on the report. In a separate meeting, the Ministry of Finance explained the budgetary pressures that led to Malaysia's recent decision to sharply decrease fuel subsidies and noted the government intended to gradually dismantle price controls on food with the hope that economic growth and increasing income would cushion the blow. The Ministry of Finance also informed DAS Dohner it would be sending a representative to hold non-binding discussions on government procurement at the July round of our bilateral FTA negotiations. Subsequent discussions with Malaysian economists emphasized the difficulties caused by Malaysia's price controls. END SUMMARY.

FOREIGN EXCHANGE REPORT

¶2. (SBU) DAS Dohner's July 1 meeting with Bank Negara Assistant Governor Lillian Leong began with a readout on U.S. financial market issues and the U.S. economic outlook. At Leong's request, DAS Dohner then provided an overview of Treasury's discussion of Malaysia in its bi-annual FX report. Dohner pointed out that the U.S. did not determine that Malaysia manipulated its currency; in fact no country has been designated a currency manipulator since 1994. Rather, the report said Malaysia's current account surplus and low domestic investment suggests an undervalued currency that has contributed to macroeconomic imbalances. He said it was a matter of misalignment, not manipulation. Dohner referred the central bank representatives to the annex of an earlier report that outlined how the U.S. Treasury judged possible misalignment and explained that China and Malaysia were at or near the top of list for the various indicators used in its determination. These indicators include the size and growth of reserves, curr
ent account balances, and contribution of net exports to growth.

¶3. (SBU) Bank Negara's Strategy Department Director Sukdave Singh responded that based on Treasury's indicators, there were other countries that should have been highlighted but were not. Singh and DAS Dohner then exchanged views on Saudi Arabia which maintained a fixed exchange rate and Singapore which Singh noted had a significantly higher current account surplus and reserves and than Malaysia. DAS Dohner explained

that Treasury looked at an extensive range of indicators for the individual country examined. He noted the failure of investment to recover in Malaysia after the Asian Financial Crisis and the fact that the real exchange rate had not appreciated despite Malaysia's surplus and the substantial terms of trade improvement.

¶4. (SBU) Singh expressed Bank Negara's view that Malaysia's economic indicators were affected by their status as a small, open economy and a recent positive terms of trade shock. Singh asserted that 70 percent of Malaysia's trade surplus was due to commodities. This was not because Malaysia's exchange rate was cheap, but rather, because "the world wants Malaysia's commodities," he said. Singh also noted that exchange rate volatility would harm Malaysia's large electronics export sector, which is part of global processing trade. Financial markets wanted a 15-20 percent increase in one year, something that perhaps could be accomplished in three years, he said. Singh reiterated that one should expect a current account surplus for Malaysia. He cited Malaysia's aging society as having an impact on the savings-investment gap, although it should be noted that Malaysia has a lower dependency ratio than other countries in the region.Singh also pointed out that the types of investments have changed from large infras
tructure projects and multinational corporations to smaller investments in the services sector and government spending in small-scale projects like schools instead of highways and bridges. Finally, Bank Negara made it apparent they are managing the ringgit with respect to Malaysian trade partners, with Singh mentioning that "if our trade partners appreciate, we will too."

¶5. (U) DAS Dohner explained that Treasury clearly drew a different conclusion than Bank Negara on the overall meaning of Malaysia's macroeconomic indicators, but suggested Bank Negara provide Treasury with a written summation of its views for Treasury's consideration. DAS Dohner said he believed Treasury's report was fair but was open to making additional efforts to exchange analysis to make sure the U.S. report is accurate. He also offered to send Treasury's Malaysia desk officer on TDY to Bank Negara to work with them directly. Leong politely thanked DAS Dohner but did not take him up on this offer.

FUEL SUBSIDIES

¶6. (U) At the Ministry of Finance, Deputy Secretary Ibrahim told DAS Dohner the June 6 price hike for subsidized gasoline and diesel by 41 percent and 63 percent respectively came as a shock to the Malaysian public (reftel). Ibrahim explained that the move was necessary to reduce the government's fiscal burden. He pointed out that there had been no price increase for just over two years and, with global prices skyrocketing, the Government had little choice. He said future increases were under consideration.

¶7. (U) In a separate meeting, Dr. Yeah of Rating Agency Malaysia confirmed that Malaysia's oil and gas subsidies were unsustainable. Approximately 40 percent of current revenue was being spent on oil and gas subsidies, he said, amounting to 6 percent of GDP. While the GOM was reasonably comfortable with a small deficit in its development budget, seeing this as a worthwhile investment in the future of the economy, petroleum subsidies were cutting into its operating budget and contributing to a higher debt-to-export ratio. Malaysia was worried about being downgraded by ratings agencies, and probably would have been, had the GOM permitted debt to exceed 50 percent of export revenues.

OTHER PRICE CONTROLS

¶8. (SBU) Dr. Yeah discussed broader price controls in the Malaysian economy. Usually only end-user prices are

controlled, with rising input costs eroding producers' profit margins until they demanded that the GOM allow them to increase prices. Typically the GOM would relent only when "their backs were against the wall" and production began to be cut, he said. Dr. Yeah also expressed concerns over the quality of Malaysia's CPI, which heavily weights controlled prices and unrepresentative goods.

¶9. (U) Dr. Yeah pointed out that when the effects of the July 1 increases in electricity and natural gas rates come through, this will result in "massive adjustments." He was not sure how the Malaysian economy would be able to cope with the shocks and noted there was political pressure on Bank Negara to hold the policy interest rate steady. Bank Negara Governor Zeti had just announced a revised economic growth forecast of 4 to 5 percent of GDP for 2008, down from 6 to 7 percent forecast earlier. In February, RAM revised its forecast to 5 percent.

TRADE NEGOTIATIONS

¶10. (U) With regard to ongoing multilateral and bilateral trade negotiations, Dohner pointed out to Ibrahim the importance of Malaysia offering more than the existing market access. He said the biggest sticking points were services, including financial services, and government procurement (GP). Ibrahim responded that the GOM was "going through its internal processes," and MITI Minister Muhiyuddin was requesting a new mandate from Cabinet. He said Muhiyuddin hoped to have a broad, national mandate to negotiate a deal that would be good for Malaysia, rather than having each Minister focus only on equities under his or her purview.

¶11. (U) The Ministry of Finance would "be on the team" for the July 14-18 free trade negotiations in Washington, Ibrahim said. The Ministry would send Dato' Zalika, the person who had been the key GP negotiator in previous rounds. She no longer covers GP but has a grasp of the issues necessary for a brainstorming session.

COMMENT

¶12. (SBU) Bank Negara was passionate in its defense of its currency, reiterating that their exchange rate regime operated according to what they termed the "rules of the game". However, it is clear that Malaysian authorities are attempting to control the price level, the exchange rate, and the interest rate, leading to a macroeconomic policy juggling act. As Malaysia faces an increasingly challenging global environment, the government's ability to meet all of these objectives will be tested.

¶13. This cable was cleared by DAS Dohner.
KEITH